DENTONS

Significant DC changes ahead
Our Insight

January 2025

The landscape of the UK pensions market is potentially on a cusp of significant transformation, driven by the Government's consultation on reforms to the Defined Contribution (DC) pension market. This initiative, spearheaded by the Department for Work and Pensions, aims to consolidate schemes, streamline governance, and refocus investment strategies to deliver better outcomes for savers while stimulating economic growth within the UK. It is a very big ask.

As the consultation unfolds, it has generated considerable interest and debate among stakeholders, including pension providers, employers, and legal experts. The deadline for responding to the consultation was 16 January, and we are pleased to be able to share with you an overview of our consultation response. This article offers insights into the legal and practical implications of the proposed changes and sheds light on the opportunities and challenges that we believe lies ahead for the pensions industry and its stakeholders.

Background and objectives of the consultation

The Government characterises the UK pensions market as one that has a wide array of schemes, each with its own set of rules, governance structures, and investment strategies. It views the current pensions landscape as a complex and fragmented market, making it challenging for savers to navigate and for policymakers to regulate effectively. In response to these challenges, the Government has embarked on a consultation process to reform the DC pension market, with a focus on achieving greater scale and efficiency.

With over 1,000 DC schemes of 12 members or more currently operating, the Government's goal of "fewer, bigger, better-run schemes" aims to leverage economies of scale and foster diversification in investments. Respondents to the earlier Call for Evidence expressed strong support for these objectives but cautioned against unintended consequences such as reduced competition and innovation.

The key objectives of the consultation, explored further below, are:

1. Achieving scale and consolidation to enhance investment opportunities and savers' outcomes.
2. Introducing contractual overrides to simplify asset transfers in contract-based arrangements.
3. Balancing costs with value to improve decision-making by employers and advisers.

1. Achieving Scale in the DC Market

The Government's initiative to achieve scale in the DC market is driven by the belief that larger schemes can deliver economies of scale, improved governance, and access to diverse investment opportunities, ultimately benefiting savers.

The Government outlines two central measures:

Limiting the Number of Default Funds:

- Reducing fragmentation by capping the number of default funds that providers can offer.

Introducing Minimum Size Requirements:

- Setting thresholds for the assets under management (AUM) at default fund level to encourage consolidation and increase investment capability.

Benefits and Risks

While these proposals have merit, they also present significant challenges:

Restricting Default Funds:

The Government's suggestion to limit default fund numbers is intended to simplify the market and enhance efficiency. However, this approach risks oversimplifying a highly nuanced system. Employers often select default funds based on their workforce's unique demographics and needs. Restricting options may undermine their ability to provide tailored solutions. Our response underscores that imposing arbitrary limits could stifle innovation and reduce competition. Providers, particularly smaller ones, may struggle to adapt, leading to an overly concentrated market dominated by a few large players.

Minimum Size Requirements for AUM:

The proposed AUM thresholds aim to enable larger-scale investments, such as infrastructure and private equity, which offer higher returns. However, the blanket application of such thresholds risks penalising smaller providers that cater effectively to niche markets or specific demographics. We argue that scale alone does not guarantee better outcomes. Investment diversity, member engagement, and the ability to innovate are equally important factors that must not be overshadowed by a singular focus on size.

Our Position

To achieve the objectives without jeopardising market diversity, we have recommended the following:

Gradual Implementation:

A phased approach to consolidation can prevent market instability. Smaller providers should be given sufficient time and support to adapt or merge, ensuring that savers are not adversely impacted by sudden changes. Regulatory guidance must accompany this transition, offering clarity on compliance requirements and potential exemptions for innovative schemes.

Tax Incentives:

Incentivising investments in productive asset classes through targeted tax benefits can drive desired outcomes without mandating size thresholds. This approach allows schemes to pursue optimal investment strategies without being constrained by regulatory rigidity.

Encouraging Organic Consolidation:

Market forces are already driving consolidation among smaller schemes. Enhancing transparency and standardising reporting metrics can further facilitate this process. Employers and trustees equipped with clear, comparable data are better positioned to make informed decisions about merging or transitioning to larger providers.

Enhancing Member Engagement

Consolidation offers an opportunity to improve member engagement. Simplified structures and fewer default options can enhance transparency, making it easier for members to understand their savings journey. This will be best facilitated by digital tools, such as interactive platforms that provide real-time insights into fund performance and individual savings trajectories. Clear communication is also key. Members must receive detailed, jargon-free explanations of changes and their benefits. Workshops, webinars, and personalised correspondence can bridge information gaps and build trust.

2. Contractual Overrides for Asset Transfers

The central proposal in Chapter 3 of the consultation paper is to enable contractual overrides for contract-based pension arrangements. This would allow providers to transfer savers from underperforming schemes to those offering better value, without needing individual consent. The Government argues that this mechanism is essential for overcoming the inertia that often prevents savers from moving to more beneficial arrangements.

Key proposals are:

Contractual Overrides for Bulk Transfers:

Providers would be empowered to transfer members from one scheme to another without requiring individual consent, provided the transfer is deemed to deliver better outcomes for savers. Legislative changes would align the regulatory framework for contract-based arrangements with trust-based schemes, where such transfers are already possible.

Safeguards and Oversight:

The proposals include provisions for Independent Governance Committees (IGCs) to assess the suitability of transfers, ensuring that member interests are prioritised. Additional protections, such as opt-out options for members and clear communication requirements, are also proposed.

Benefits and Risks

The introduction of contractual overrides offers several advantages but also raises potential concerns. The ability to transfer disengaged savers from underperforming schemes will drive faster consolidation, enabling economies of scale and improved investment opportunities. Members would benefit from being part of better-performing schemes with enhanced governance and lower costs.

However, overriding individual contracts without explicit consent may face legal and ethical challenges, particularly if savers are unaware of or opposed to the transfer. Implementing a robust framework to assess and execute transfers will require significant resources and expertise.

Our Position

We support this proposal, provided it includes rigorous safeguards. IGCs should conduct comprehensive assessments, comparing new arrangements against existing ones. Additionally, savers must retain the right to opt out, minimising potential backlash.

Support for Oversight and Safeguards

We are advocating for the involvement of IGCs to ensure that transfers without consent are in savers' best interests, emphasising the importance of trust and transparency in the pensions system. We have highlighted the need for robust safeguards, clear communication to savers about the implications of transfers, and the provision of an opt-out option to protect savers and maintain the system's integrity.

Concerns About Implementation and Consumer Protections

Whilst recognising the potential benefits of contractual overrides, we have raised concerns about their implementation, urging rigorous and transparent processes for assessing transfers. We have emphasised the necessity of consumer protections, including the availability of compensation or legal recourse for savers who suffer losses due to transfers, and we advocate for a robust framework to prioritise saver confidence and accountability.

Impact on Saver Trust and Engagement

We have warned that transfers without consent could undermine saver trust and engagement if not handled transparently. Our response recommends clear communication to reassure savers about the benefits of transfers and address concerns regarding their retirement outcomes, as effective communication is crucial for maintaining confidence in the pensions system.

Implications for Market Competition

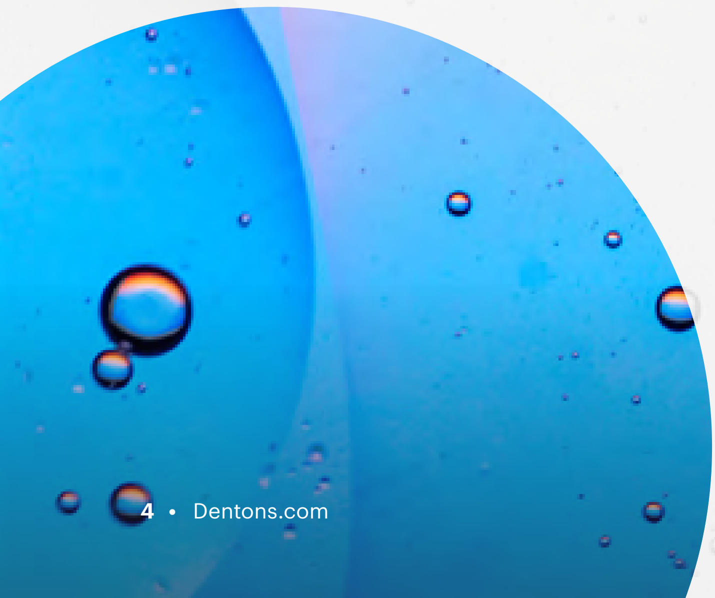
Contractual overrides could lead to market consolidation, potentially improving efficiency but risking the exclusion of smaller providers, which could reduce choice for savers and employers. We have called for measures to promote competition, prevent excessive concentration of market power, and ensure continued innovation within the pensions sector.

Considerations for Regulatory Oversight

The role of regulatory oversight is a key factor in the consultation. We highlighted the need for the Financial Conduct Authority and The Pensions Regulator to have adequate powers and resources to oversee and enforce the proposed transfers. We also advocated for clear guidelines and criteria to ensure accountability and protect savers, alongside collaboration between regulators, providers, and stakeholders to uphold the integrity of the pensions market.

Ensuring Equity in Transfers

Transfers must prioritise equity among savers, particularly in relation to legacy arrangements. Our response suggested the development of a standardised framework for evaluating the suitability of new arrangements, incorporating metrics such as historical performance, cost efficiency, and alignment with long-term savings objectives. Clear timelines and transparent reporting mechanisms would further enhance trust and accountability. Additionally, we proposed an independent review mechanism for disputed transfers, offering additional protection for consumers while maintaining the integrity of the consolidation process.



3. Balancing Costs and Value

The UK Government's consultation paper underlines the importance of moving from a focus on costs to a broader emphasis on value for money (VFM). Chapter 4 of the consultation seeks to clarify the role of employers and their advisers in ensuring workplace pension schemes deliver long-term value.

The consultation introduces several measures aimed at aligning employer and adviser decision-making with the goal of delivering value for members. These include:

Executive Responsibility:

Proposing a named executive responsible for overseeing staff retirement outcomes. This aims to promote accountability within organisations and elevate the quality of employer decision-making.

Employer Duty to Consider Value:

Introducing a statutory duty on employers to consider value rather than cost when selecting or reviewing pension arrangements. This measure is intended to address evidence that many employers prioritise costs due to ease of comparison.

Regulation of Advice:

Exploring the regulation of currently unregulated advice provided to employers on scheme selection. The aim is to improve the quality and consistency of advice and ensure it aligns with the best interests of members.

Enhanced Oversight:

Considering oversight mechanisms for employers and advisers to ensure compliance with the new duties, including penalties for non-compliance and clearer frameworks for assessing VFM.

Benefits and Risks

Shifting the focus from cost to value is expected to lead to better long-term returns for members, particularly if employers prioritise schemes with strong investment performance and governance. Naming an executive responsible for retirement outcomes could increase accountability within organisations and encourage a more strategic approach to pension governance. Regulating advice could help ensure that employers receive high-quality guidance, reducing the risk of suboptimal scheme selection.

However, small and medium-sized employers may struggle to meet the proposed duties without incurring significant costs or requiring additional resources. There is a risk that naming an executive could lead to a procedural approach rather than substantive improvements in governance. The focus on VFM, while beneficial, may lead to reduced competition among providers and an overemphasis on metrics that are easier to compare, such as cost, at the expense of nuanced qualitative assessments.

Our Position

While we support the Government's intent to drive value in pensions, we believe several refinements are necessary to ensure the measures are effective and proportionate.

Clarify the Scope of Employer Duties.

The statutory duty to consider value should define value clearly. The definition of value must encompass qualitative factors such as governance, investment strategy, and member engagement, rather than being limited to quantitative metrics like charges. It should also tailor duties by employment size. To prevent overburdening smaller employers, duties should scale proportionally. For instance, small employers could rely on simplified compliance tools provided by regulators.

Strengthen Adviser Regulation.

To improve the quality of advice, the Government should extend regulatory oversight to all advisers providing guidance on pension scheme selection, including those offering investment advice to trustees and IGCs. It would also be advisable to mandate a baseline level of qualifications for advisers, ensuring consistent standards across the market.

Introduce Incentives for Value-Driven Behaviour.

Rather than relying solely on duties and penalties, the Government should provide a tax incentive, encouraging employers to select high-performing schemes by offering tax benefits linked to demonstrable improvements in member outcomes. The promotion of best practices would also be advisable, examples being the publishing of case studies and benchmarks to guide employers in selecting value-driven schemes.

Balance Accountability with Practicality

Naming an executive responsible for retirement outcomes should be flexible, allowing employers to delegate responsibilities to external experts or committees where appropriate, particularly in large, complex organisations. There should also be a focus on outcomes, emphasising the substantive delivery of value rather than procedural compliance.

Enhance Oversight Mechanisms

Oversight should leverage existing structures, utilising existing reporting frameworks, such as VFM assessments and TPR's guidance, to minimise duplication. We have also recommended encouraging collaborative governance, requiring employers with trust-based schemes to work closely with trustees to align on value objectives.

Conclusion

The Government's proposals represent an ambitious effort to reform the UK pensions market. While the objectives are commendable, the implementation must be carefully calibrated. Key priorities include maintaining market diversity, protecting consumers, and fostering innovation.

As the consultation progresses, continued dialogue between policymakers, industry stakeholders, and advisers will be vital. By striking the right balance, these reforms can unlock the potential of the UK pensions market, delivering better outcomes for savers and driving economic growth.

With thoughtful implementation, the UK pensions system can evolve into a robust, globally competitive model that benefits savers and the broader economy alike. Collaboration and transparency will be the cornerstones of this transformation, ensuring that the sector remains resilient and adaptable in the face of future challenges.

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